DOW THEORY LETTERS INC.

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Subscriber: Russell, what in the devil do you think this market is up to?

Russell: Well, let's review the recent action. We had a 99 point Industrial drop between May 14 and June 25. At the June lows (Chart 1), Industrials were 840.59, Rails 187.29. Next we saw a 4 day rally which recovered 40% of the ground lost. Then between July 2 and July 19 the market edged up as volume went dead. On July 20 (last Tuesday) the market broke badly as volume expanded. After the close of the market we were all surprised to hear that the short interest had jumped 1.2 million to an all-time high of 7.2 million. The market weakness continued, however, and by Thursday we were back within striking distance of the June lows.

Subs: All right, we're within range of the lows again, but what do you look for now?

Russell: This market is dangerous and tricky. It's true that it's packed with a record number of shorts, but it's very old and it's building (or completing) a major top. Make no mistake about it, the market is (as it always is) out to make fools of us all. Here's what I am looking for in the period ahead. If, in the next few weeks, both Averages break through the June lows (840.59 and 187.29) on high volume you can bet that there are going to be a lot of scared bulls and a lot of bears with profits under their belts. Such a joint penetration could signal the start of a drastic decline. Yes, I know about the shorts, but remember, we have already had a bear signal. And if the primary trend is down, the shorts are now speculating with the primary trend. We saw this occur in 1931 when a whopping 5.6 million sharts were right about the bear market. Between April and December, 1931, the Industrial Average cut itself in half.

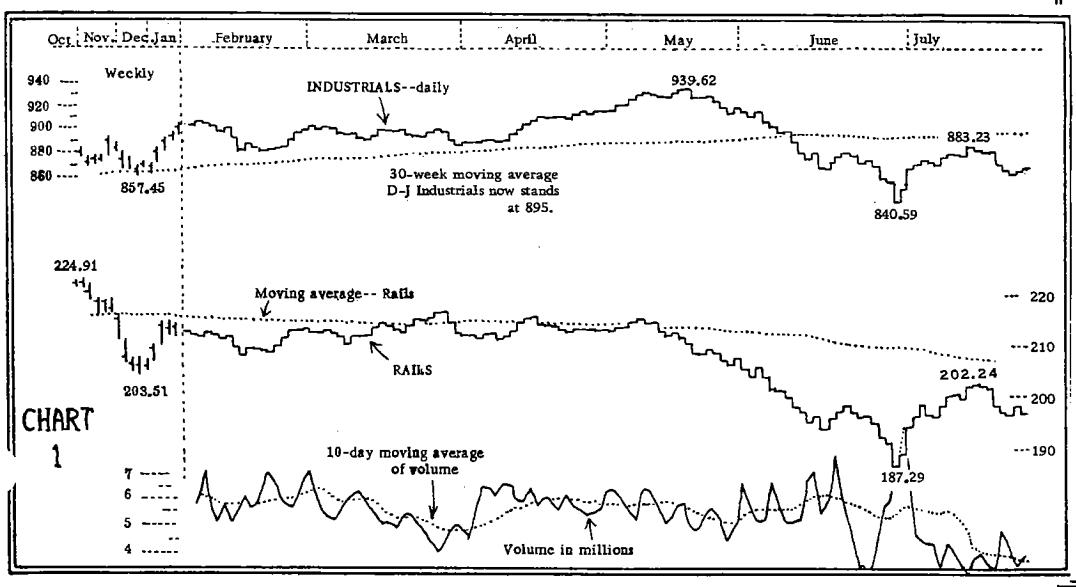
Subs: I see. But what happens if the Averages refuse to break the lows on big volume?

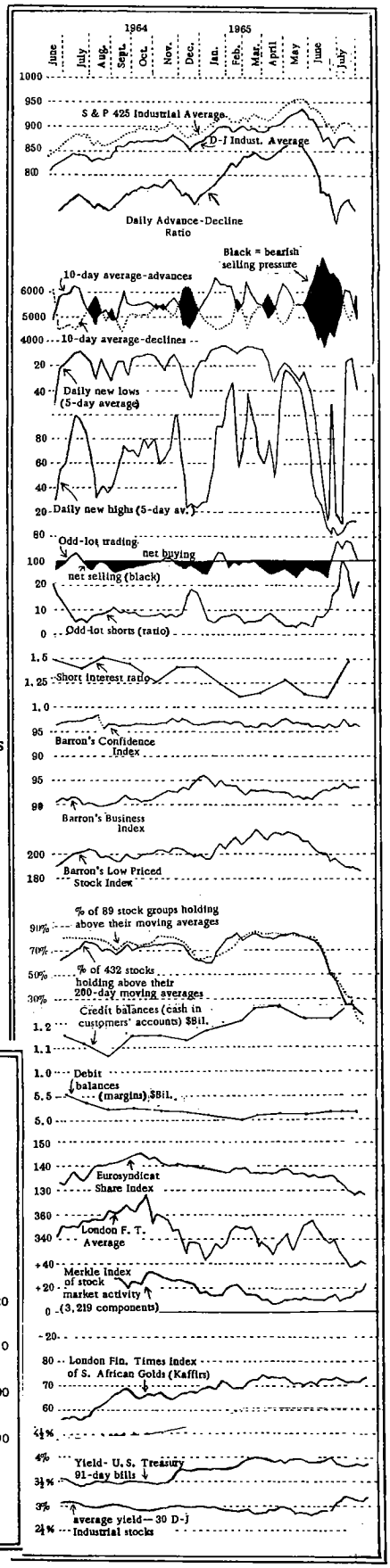
Russell: Remember, a large group of shorts can be right — but (unfortunately for them) they can be right too soon (and that is why I have advocated buying one year put options instead of shorting). Now, this is the way I see it: if we "test" the June lows and one or both Averages fail to confirm on the downside or if they both penetrate on very low volume (low volume could be a "fooler") watch out! If any of these occur or if the Averages halt this side of the June lows and start zig-zagging up, then we're liable to see a straight-up climb as the shorts are routed. In that case, to put it mildly, we could have an explosive final rise.

Subs: That sort of rise could complete the "broadening formation" you talked about in Letters 292 and 293, couldn't it?

Russell: Yes, but of course to complete the broadening pattern Industrials would have to surge to a new high (above 939.62), then collapse. Which, by the way, is exactly what I'd expect if we don't get a penetration by both Averages through the June lows.

Subs: If the Averages refuse to break the June lows, would you personally buy for the rally?




1964
1965
June July Aug. Sept. Oct. Nov. Dec. Jan. Feb. Mar. April May June July
S & P 425 Industrial Average
D-J Indust. Average
Daily Advance-Decline Ratio
Black = bearish selling pressure
10-day average-advances
10-day average-declines
Daily new lows (5-day average)
Daily new highs (5-day av.)
Odd-lot trading
net buying
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low Priced Stock Index
% of 89 stock groups holding above their moving averages
% of 432 stocks holding above their 200-day moving averages
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London F. T. Average
Merkle Index of stock market activity (3,219 components)
London Fin. Times Index of S. African Golds (Kaffirs)
Yield- U.S. Treasury 91-day bills
average yield—30 D-J Industrial stocks

Russell: Ordinarily I would say no, but with 7.2 million shorts in this market, I believe I might be tempted to "play" the upside if we fail to break to new lows here — particularly if we get a downside non-confirmation (one Average breaking below the June low while the other refuses).

Subs: Well, it looks like an exciting summer. Either we get another bear leg as the Averages go through the June lows on big volume, or we get a turn-around, a rush for the highs and then another decline.

Russell: Don't say "another decline." In the event that we rally here, my guess is that if the highs are approached or bettered (which would amaze everyone) this market could turn around and crash on bigger volume than anything yet seen. Don't forget, a rise from here would come (1) after a primary bear signal, (2) in the face of deteriorating fundamentals as evidenced by bank credit studies, (3) in the face of bear markets in almost all the other stock markets of the Free World, (4) in the face of steady selling by large interests — as documented in "The Big Block" section of this Letter. In other words, a rally from here — even to new highs, would be strictly "technical" and against the fundamentals. Therefore, I would expect the turnaround from any new rally high to be shocking in terms of its suddeness and violence.

Subs: So investors and traders really have their work cut out for them in the period ahead.

Russell: Yes, if the Averages fail to break the June lows on big volume, and this market then turns up, traders will have a chance for a "speculative ride" and investors will have a golden opportunity to sell whatever they have not sold so far (as well as to purchase additional one year puts). On the other hand, if we now go through the June lows on heavy volume, it will be a signal that the bear market is on in earnest.

The Composite Chart (Page 1) shows both leading industrial averages sinking towards the June lows with the A-D ratio acting somewhat poorer than the averages. Selling pressure (black area) is dominant again as shown by the 10-day averages of advances and declines. New lows are beginning to expand again while new highs remain sluggish at around 13. The short interest ratio rose to 1.47 in July, which should lend impetus to the next important advance. Barron's Low-Priced Stock Index at 186.7 has fallen to a new low for the year. The percentage of stocks holding above their moving averages dropped to a new low of 20% last week while the percentage of 89 stock groups holding above their moving averages sank to a new low of 15%. Cash in customers' accounts rose to a high for the year, and this means that the public is getting out of stock and into cash, a hopeful sign. This does not check with debit balances (margins), however, which are still in a long-term downtrend (meaning that speculators are not enthusiastic). Last week the Kaffirs (S. African gold) index rose above its June peak to 73, highest level since March. This Index is going to test the March 74.2 level. Bettering 75 will constitute a major breakout, and it is worth noting that many Kaffirs are now near or at their all-time highs. Conclusion: price and breadth indicators are bearish, but psychological indicators such as short interest and odd-lots are hopeful. Primary trend is bearish. Consider the secondary trend bearish unless the July highs of 883.23 (Industrials) and 202.24 (Rails) are jointly bettered. If the July peaks are bettered, we could get an important extension of the secondary upward correction.

THE BIG BLOCKS: Early last June Barron's inaugurated a policy of tabulating all N.Y.S.E. blocks of 10,000 shares or over. This could prove to be a very valuable study over a period of time. Big blocks obviously represent "big money," and the question is — does a preponderance of "up-ticks" in big blocks (i.e., trades at higher prices than previous trades) suggest big money accumulation, and is the converse true where a preponderance of "down-ticks" appear. My own opinion is that there is a definite correlation between a continuing majority of up-ticks and a market that is under "big block accumulation," and the converse is true in the case of a continuing series of big block down-ticks. Mr. Donald Worden (Worden Tape Reading Studies) has made a careful and scientific study of big block transactions in much more depth than could possibly be offered here. Suffice it to say, however, that Mr. Worden's studies conclude that a great deal of importance should be attached to the tabulation of up-ticks or down-ticks in large blocks.

I have been working out statistics on the big-block transactions since Barron's started these listings. I have handled them as follows: if there have been more up-ticks than down-ticks, I subtract the down-ticks from up-ticks and then divide by the total number of big blocks traded that week. This provides a ratio. I will probably run these ratios in the form of a 10-week moving average as soon as there is sufficient history.

Question: Why divide by number of transactions? Answer: this is a necessary adjustment. If during a given week 5 blocks are up, 10 are down and 10 unchanged (total 25), we get a ratio of minus 20. But if the next week shows 5 up, 10 down and only 16 total blocks we get a much more bearish picture (since 10 out of a total of 16 transactions were down instead of the previous 10 out of 25 down) and the ratio during the second week is minus 31.

Question: Are you going to incorporate these figures in the Composite Chart? Answer: I am going to comment on them weekly, and if they prove themselves (which I believe they will) they will be shown on the Page 1 Composite Chart.

The ratios for the weeks since June 7 are as follows — June 7, minus 40; June 14, minus 39; June 21, minus 43; June 28, minus 19; July 6, minus 39; July 12, minus 42; July 19, minus 59. In actual figures since June 7, 206 big blocks were listed. Of these 20 were up-ticks and 99 were down-ticks. There were actually about five times as many down-ticks as up-ticks! One thing is sure, this study shows that big money is distributing stock in the market week after week. Therefore, those who are looking to big money to take this market up from here will have to look for their bullish impetus elsewhere. The big money is not buying here, it is getting out.

TESTING: In Letter 291 I wrote about a "test" which I apply to the market. When the market is in a basically bullish trend it produces what I termed "good days," and these good days often appear in strings of three, four or five in a row. During a real bull trend few "bad days" appear — even during sharp declines. Conversely, during a strong bear trend the market produces many consecutive bad days, but good days (even during violent upward corrections) are very scarce. A good day is identified as follows: (1) All three averages, Industrials, Rails and Utilities, rise together in both the D-J and Standard & Poor Averages; (2) volume expands compared with the preceding

day; (3) there are more advances than declines; (4) there are more daily highs than lows with new highs generally expanding above the total for the preceding day. To identify a bad day, simply reverse all the above listed criteria.

It is interesting to note that since June 29 (the first day of the June-July rally) only a single good day appeared. I have classified all the days since the June lows, and I would like subscribers to study these tabulations carefully:

June 29 — Market rallied but volume down.
June 30 — Market rallied but more lows than highs and volume down again.
July 1 — Market still rallying but volume down.
July 2 — Market rallying but volume down.
July 6 — Market declined on lower volume.
July 7 — Market declined on lower volume again.
July 8 — Market rallied but more lows than highs.
July 9 — This was the first good day.
July 12 — General market up but Industrials down.
July 13 — Market declined with volume lower.
July 14 — Market rallied but Utilities down.
July 15 — Rails up, Industrials and Utilities down.
July 16 — Market declined on lower volume.
July 19 — Market declined again on lower volume.
July 20 — The first bad day appeared with volume up and everything down.
July 21 — Market down again but volume lower.
July 22 — Market down and volume lower.
July 23 — Market up, Utilities down, more lows than highs.
July 26 — Industrials up, but Rails, Utilities down. More lows than highs.

Conclusion: all market action since the June lows must be considered part of the rally attempt. So far, the rally has produced only a single good day.

SUNDRY COMMENTS: Last week it was reported that several foreign central banks outside the London Gold Pool were buyers of gold at the Pool. There were reports of heavy private buying, and on Wednesday 40 tons of gold changed hands, which constituted the largest single day of gold sales in 20 years. In an attempt to hold down the price, the Bank of England was forced to sell gold again last week. The Gold Pool is owned 50% by the U. S., and the fresh gold purchases will probably show up here shortly in the form of new gold losses. The intense wave of interest in gold is being reflected in the gold price, and I have included a weekly chart showing the price of gold in London since mid-1963. Following the January, 1965 high and the break to the May-June "consolidation area," the price of gold last week jumped to a three month high (chart, Page 4).

FRANCE AND DeGAULLE: Twenty years ago France was considered a "third rate power," written off by the rest of the world as a remnant of the once proud and glorious Republic which had led all of Europe. During World War II France, rotting and inefficient, collapsed within a matter of days in the face of German might. The leader of the Free French, Charles DeGaulle, attempted to carry on the fight, but he was scorned or ignored by allied leaders Stalin, Roosevelt and Churchill. The war's end found France tottering, derided as the "sick man of Europe." But since the war France has staged a remarkable return to power and prominence. The return was due in large measure to the inspiration, the genious, the arrogance, the will and the stubborn determination of one man — DeGaulle.

France has always required a strong man to lift it to greatness, whether that man was Louis XIV, Napoleon or DeGaulle. DeGaulle is deemed by many to be either mad or the only leader of the Free World with great vision. For years DeGaulle's many enemies have insisted that the first diagnosis is the correct one, but so far events suggest the possibility of the second. To understand DeGaulle it is necessary to recognize that the General is possessed by one overriding ambition — to see France rise to its former position of greatness. At this point in history, DeGaulle's dream has perhaps been only half satisfied.

What and who is behind DeGaulle's thinking? DeGaulle is one of the few leaders of the world who listens to and is guided by conservative economists. One of the foremost of these is the famous Jacques Rueff, the man who stated (when other nations recently scorned his "return to the gold standard" speech) that "one is never so right as when he is alone."

DeGaulle has made monetary conservatism an integral part of his political program. His "stabilization plan" is aimed at holding down prices and the money supply, and despite its political unpalatability, it has produced excellent results in France.

In this writer's opinion, DeGaulle foresees world economic trouble ahead (certainly Rueff has been repeatedly warning of an economic disaster). If this is true, it explains why France is now building up its reserves at a faster rate than any nation in the world. As a comparison, since 1960 the U. S.'s reserves of gold and foreign reserves have dropped from $17.8 billion to $15.5. During the same period France's reserves have risen from $2.1 billion to $6.0. Thus while the U. S. reserves have been steadily dropping, France has almost tripled its own reserves since 1960.

DeGaulle believes that France, with its relatively high reserves and its conservative economic policies, will be in an excellent position to withstand a possible world economic collapse. The recent French deflationary programs are calculated to keep France "near the ground" when and if trouble comes. Furthermore, DeGaulle knows that fiscal power brings world respect. He is therefore pushing to make the franc a part of the world reserve system or at least to remove the dollar as the leading reserve currency (the pound is already unsatisfactory because of its weakness). But regardless of the system which the French want, they wish the key monetary decisions to be made at the Paris Club and not in the "Anglo-Saxon" dominated International Monetary Fund.

With his rising monetary power, DeGaulle is ready to assert political power. DeGaulle looks at the 900 million Chinese and guesses that within 20 years China will be a nation very much to be reckoned with. DeGaulle sees Russia's Asiatic provinces coming under increasingly strong Chinese influence, and he feels that under the threat of an expanding China, Russia will "see the light" and find that its interests lie with Europe, not with Asia. DeGaulle believes that Europe will ultimately be led by France and Russia, and this is what he means when he refers to a "Europe from the Atlantic to the Urals."

DeGaulle agrees with little that the U. S. is doing. He thinks it is absurd that the U. S. does not recognize China, and recently he has thwarted the U. S. by recognizing China himself. DeGaulle believes that the Vietnam war is hopeless; he has recently pulled his ambassadors out of S. Vietnam, a "nation" which he believes to be non-existant.

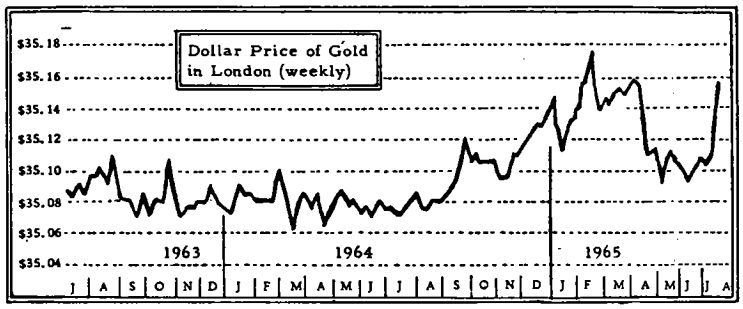
To the consternation of the Free World, DeGaulle believes that France's best interest in the dangerous period ahead will be best served by "power politics" and old fashioned nationalism (both of which will provide DeGaulle with "elbow room" to maneuver in the international political arena). The General does not want a Union of European States and he does not want the U. S. in Europe. He feels that when the chips are down, the U. S. cannot and should not be counted upon to serve Europe's interests. Part of that view stems from his appraisal of the current U. S. financial position. After all, it was France which advocated a new reserve currency while the rest of the world laughed. But now the U. S. is calling back its dollars (under pressure of its balance-of-payments difficulties) while

Europe and Japan suffer. The rest of the world is finally and belatedly beginning to doubt the wisdom of depending completely upon scarce dollars and wobbly pounds, and talk of "monetary reform" is no longer France's cry alone.

Finally, DeGaulle harbors real doubts about the U. S.'s ability in the period ahead. He doubts our military, political and financial wisdom. He is convinced that he is correct and that the U. S. is wrong. So France continues to impose severe monetary discipline while building up its reserves and exerting its own brand of power politics. DeGaulle may indeed be "mad" as so many sincerely believe, but that interpretation has yet to be proved — at least to the satisfaction of this observer.

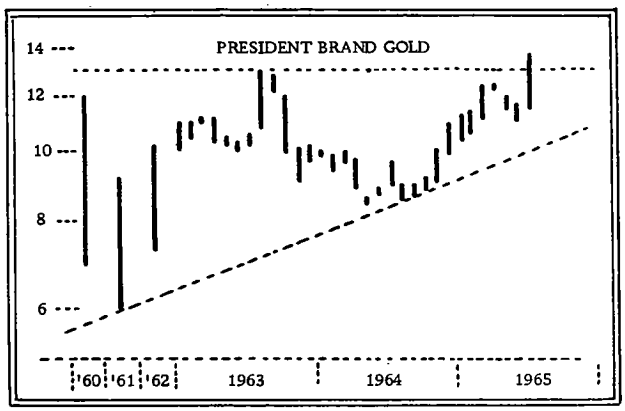
One of the reasons for renewed interest in gold is the possibility of a multi-nation agreement to raise the price of gold this fall. It is worth noting that no "official denials" have come out of Washington lately regarding a gold price rise. Our Administrations are famous for choosing the "easy way out" in monetary affairs, and the easy way now would be to raise the price of gold, thereby instantly doubling the value of our gold reserves. The logical objections to such a procedure boil down to only one — a rise in gold will allow our Government to inflate even further (but since when did a Democratic Administration ever object to more demonetization?).

The second attraction of gold at this time stems from the fact that Britain is now "bankrupt" and could take the solo path to devaluation if



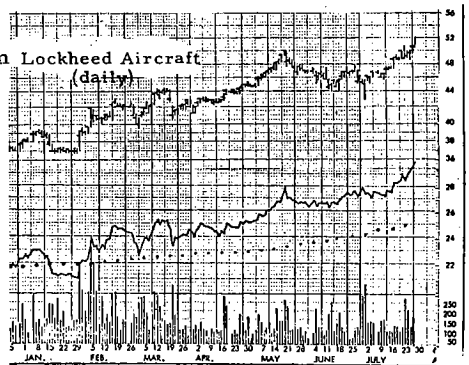
the situation gets rough enough. Indicator Digest (Palisades Park, N.J.) notes in its latest issue: "At the close of 1964 the U. K. had outstanding foreign claims against Sterling equal to $8.56 billion (net), or approximately 9.3% of the U. K.'s 1965 GNP. Even doubling the price of gold would lift U. K. reserves (which are now $2.8 Bil.) to less than half the amount necessary to cover foreign claims." Meanwhile, Britain continues to flounder in its "manipulative" dream world, and the latest issue from the (London) Economist shows British export prices 2% above the level of a year ago. The steady rise in export prices are hardly calculated (together with wide-spread pay raises) to help the British balance-of-payments.

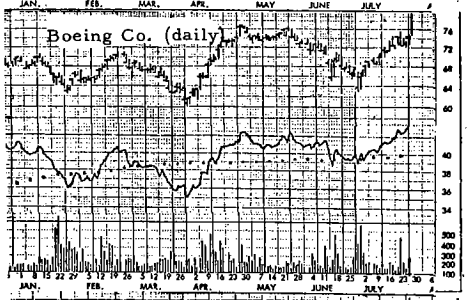
Along these lines, this paragraph from Alden Wells' latest Monetary Report (Palisades Pk., N.J.) should prove instructive: "The creation of money to the degree that people are driven to put the proceeds into stocks, commodities or real estate is, of course, irresponsible. In most cases, the process cannot be stopped, and the country undergoes a revolution. In English speaking countries, our long entrenched experience in self-government causes a halt before we completely duplicate the history of 'banana republics.' For six years we have been acting like a banana republic. In England and here we are now attempting to pull back from the abyss. The means used show as little skill as the original follishness, but the event is on both of us."

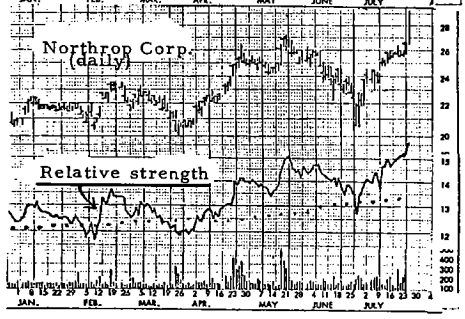


Many subscribers have never seen a long-term chart of an individual S. African gold share, and I am herewith including a chart of President Brand, a representative gold stock which has been repeatedly recommended here and which last week rose (to record high) above what appears to be a massive accumulative "ascending triangle." If any reader can find any fault with this pattern, please let me know about it.

STOCKS: With the market faltering and with the great majority of issues well off their 1965 highs, the Vietnam war continues to increase in seriousness (as I suggested it would in Letters 287 and 289), and the Wall Street picture becomes more complicated than ever. The Vietnam situation means lost lives, casualties, mounting political pressures, more spending for defense and a further drain on our dwindling reserves. The reserve drain in turn means further pressure for a rise in the price of gold, and this thought undoubtedly struck buyers last week as they piled their money into the spectacularly climbing American South African investment trust. I am assuming that most of my subscribers already have their gold positions and are not forced to make their initial commitments at current prices (although last week this writer added to his portfolio in the form of American depository receipts in Western Areas, a relatively new' good quality S. African mine selling at $4\frac{1}{4}$).







The next question is — should subscribers purchase or hold defense stocks and specifically aircraft shares? There is no questioning the fact that the aircraft act well as pointed out in Letter 292 (Lockheed). If I were forced to speculate, I would purchase a package of the four best acting (in terms of relative strength) defense stocks, and these are Boeing, Lockheed, McDonnell and Northrup. Last week each of these four issues recorded a new 1965 high in relative strength, and this means that they are at their peak of performance relative to the general market (see charts). It should be remembered, however, that the aircraft stocks are heavily dependent on the course of the war and the decisions in Washington. Events could change drastically (although at the moment all things point to "more war" and more armaments). So the policy is this — investors should be holding Treasury bills and 10 to 15% of their assets in gold shares. Traders can hold the same with the addition of a "speculative package" of aircraft shares.

Aircraft charts courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.

NOTE: The current (July 26) issue of Barron's contains an article by this writer entitled "Track of the Bear." It is a general treatise on bear markets, and I would like to recommend it to all (particularly to all new) subscribers. As a matter of fact, I want to recommend Barron's itself to all subscribers. This famous Dow Jones weekly publication together with the Wall Street Journal should comprise a nucleus of required reading for every investor.